days and partly because rehabs are rarely in the choicest locations. To lower borrowing costs, many developers float tax-exempt industrial revenue bonds through municipalities or go after federal Urban Development Action Grants—awarded to municipalities, which in turn lend the money to developers at low rates, typically about 9%. In exchange, though, municipalities require partnerships to restrict cash payouts and set aside enough money to ensure that they can service the debt.

Even when the debt-to-equity ratio is a modest 50-50, the 25% tax credit often allows limited partners to recoup 40% of their investment the year the credit is taken. (Assuming restoration costs account for 80% of the project, a $1,000 investment plus $1,000 of debt would yield a tax credit of $400—25% of $1,600.) The credit and the tax savings from depreciation often allow an investor to recoup his entire stake in just three to five years, speedy by comparison with other real-estate deals. And if the developers' projections make sense—they usually assume the building can be sold for two to 2½ times cost after ten to 15 years—the investor will get back up to four times his investment in the end.

Matching the original

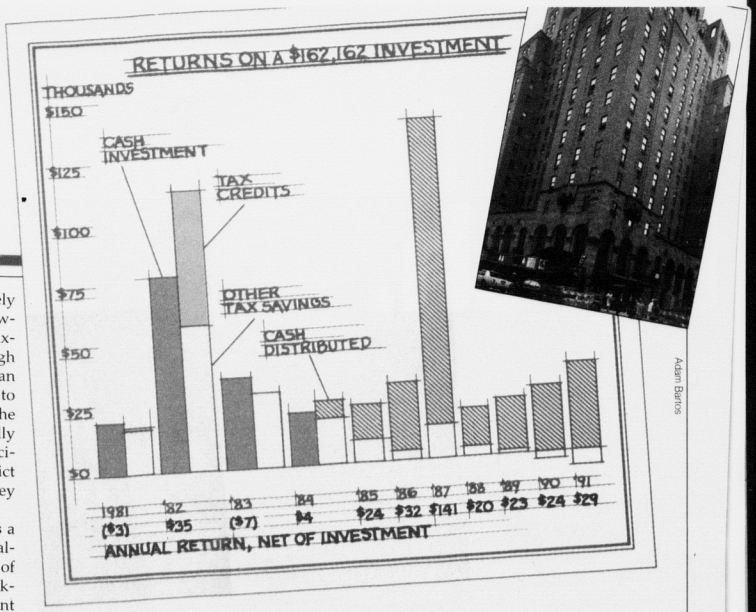
That's if things go as expected, which they never do. "In historic rehabs," says Warren Shine, a partner in Ernst & Whinney, the accounting firm, "a primary concern is whether the property will qualify for the credit." The concern lasts until the job is finished and approved by the Interior Department, which imposes strict guidelines on developers. For example, the building's original size must be retained; the design of the windows must be preserved; such features as cornices and railings, when replaced, must be made of materials that resemble the originals.

Then there are the more familiar risks of the business. According to Richard Brothers, vice president of a company set up by financier David Murdock that is rehabilitating two historic building sites in Baltimore, "The greatest risk is a construction cost overrun." These are even more likely for historic rehabs than for new buildings. As Brothers puts it: "You can never be sure what you have until you gut the inside of the building." What you have may include a defective foundation and structural features that play havoc with installing air-conditioning equipment and elevators.

Cost overruns heighten the probability of foreclosure, the worst event imaginable. Foreclosure during the first five years of the partnership would force the limited partners to cough up for the Internal Revenue Service all or part of the tax credit already taken. That is the government's way of discouraging promoters from inventing deals that don't make economic sense.

Investors should look for guarantees that protect against cost overruns and reduce the possibility of "recapture." Lyle Hall Jr., senior vice president at Butcher & Singer in Philadelphia, says, "The general partner should guarantee a fixed construction cost" and pay for any overruns. In the Cherry Street deal, the developer agreed to lend the partnership, if necessary, enough money interest free to service the debt during the first five years. Investment bankers at Donaldson Lufkin & Jenrette are designing partnerships with other novel ways of reducing investors' risks.

One of the next deals to hit the market will be an unregistered partnership that promises to be one of the biggest historic rehab projects since the advent of ERTA. Oppenheimer & Co., the New York securities firm, is raising $125 million, of which $20 million will be put up by limited partners, to rehabilitate Union Station in St. Louis. The deal has vastly greater leverage than most, so the tax benefits are high. The project is a joint venture with the Rouse Co., which has successfully rehabilitated other historic buildings. In St. Louis, Rouse plans initially to construct a hotel and an arcade of restaurants and shops. Interests in the deal, at $150,000 apiece, could go on sale in July. F



Adam Bartos

Blueprint for Barbizon Investors

A supplement to the offering memorandum for the partnership rehabilitating the Barbizon Hotel for Women on Manhattan's East Side shows these projections for partners in the 50% bracket. As is usual in such deals, the limited partners agreed to put up cash in four annual chunks—the minimum in this deal was a total of $162,162. The 25% investment tax credit and other tax savings return all of this by the end of the third year. The big distribution in 1987 will come, if all goes well, from refinancing the building at its value then, assumed to be two times cost. By 1990 the projections show more taxable income than shelter.